final DOL automatic rollover safe harbor regulations: implications & impact

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At long last, recent guidance by the Department of Labor spells out clear directives for pension plan sponsors regarding distribution of the accounts of both terminated plan participants with account balances under $5,000 and missing plan participants in terminated defined contribution plans. By following a concise 'checklist' of conditions, plan sponsors can now follow uniform standards in pursuing closure. Here's how...

As part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGGTRA), Congress enacted a provision that required retirement plans to roll over the accounts of terminated participants whose benefits due exceeded $1,000 (but did not exceed $5,000) unless the participant affirmatively opted to receive cash. However, this EGGTRA provision was not to be effective until the Department of Labor issued guidance, which EGGTRA dictated was due by June 7, 2004. Those regulations have now been finalized, and do indeed provide guidance and establish a safe harbor for plan sponsors that automatically roll over the funds in a terminated employee's tax-qualified retirement plan account to an individual retirement account. The new regulation, which goes into effect March 28, 2005, creates several important conditions that must be satisfied by plan sponsors, as well as some key implications for both sponsors and institutions.

First, the Differences

There are a number of interesting differences between what the DOL originally proposed and its final regulations. The most notable of these is the fact that the DOL extended the safe harbor to rollovers of mandatory distributions of $1,000 or less, plan sponsors could automatically cash out accounts valued at $1,000 or less, but if a plan sponsor preferred to roll over these smaller amounts into an IRA, under the originally proposed regulation, the safe harbor protection was not available to protect the plan sponsor.

Second, while the proposed DOL rules were, by and large, regarded as favorable by the institutional community, there were a few aspects that had the institutional community up in arms. The most troubling of these was the fact that, while an institution could charge the new IRA accounts an initial set-up fee, ongoing administration fees were limited to the amount of income that the account earned. Since these accounts were required to be invested in stable value, short-term fixed-income type accounts, the limits on administration fees were clearly unattractive to potential IRA providers. Additionally, some argued that this restriction would ultimately limit the number of individual retirement plan providers that would be willing to accept rollover distributions in accordance with the safe harbor regulation.

In the DOL's final regulations, however, this restriction was eliminated, and now institutions are merely required to charge fees that are comparable to those charged for other IRAs. The DOL states that the "comparability standard" is sufficient to protect individual retirement plans from being assessed unreasonable fees.

Conditions for Safe Harbor Relief

To secure protection under the new safe harbor, fiduciaries must now satisfy six conditions:

Distribution Amount. Automatic rollovers are limited to distributions that don't exceed $5,000. In short, the safe harbor applies to any distribution that is $5,000 or less (no $1,000 minimum anymore).

IRA Providers. Automatic rollovers may only be made to IRAs and individual annuities maintained at:

- A state or federally regulated bank or savings association (the accounts of which are FDIC-insured);
- A credit union (the accounts of which are CUNA-insured);
- An insurance company (whose products are protected by state guaranty associations);
- A mutual fund company (regulated under the Investment Company Act of 1940); or
- Another financial institution eligible to offer IRAs under Treasury Dept. regulations.

What's more, the distributing plan's fiduciary must enter into a written agreement with the IRA provider that specifically addresses the investment of rolled-over funds and attendant IRA fees and expenses.

Investments. Investments deemed permissible under the new rules must be designed to preserve principal and provide a reasonable rate of return. The preamble to the regulation notes that the following products would typically meet this requirement:

- Money market funds maintained by registered investment companies;
- Interest-bearing savings accounts and CDs of banks or similar financial institutions; and
- Stable-value products issued by regulated financial institutions that are fully benefit-responsive.

Fees and Expenses. IRAs receiving automatic rollovers may only provide for fees and expenses that do not exceed the amounts charged for comparable IRAs that are not established to receive automatic rollovers.

Participant Notices. Prior to using the safe harbor for an automatic rollover, participants must be furnished with a Summary Plan Description or a Summary of Material Modifications that not only explains the investment product in which the distribution will be invested, but also clarifies the extent to which the IRA fees and expenses will be borne by the individual alone or shared with the distributing plan or plan sponsor. A plan contact must also be specified.

Prohibited Transaction Class Exemption. The safe harbor is not available where the distributing plan fiduciary engages in a nonexempt "prohibited transaction" under ERISA in connection with the selection of the IRA provider or investment products. What this means is, the receipt by a plan fiduciary of compensation from a financial institution as a result of selecting that financial institution would ordinarily constitute a prohibited transaction under ERISA. Fortunately, the DOL also issued an exemption to this rule, Class Prohibited Transaction Exemption 2004–16, permitting a bank or other financial institution to select itself, or its affiliate, as the IRA provider for automatic rollovers from its own retirement plans. The exemption also allows a bank (or other such institution) to choose its own funds or investment products for the investment of automatic rollovers. However, it is important to be aware that, while the institution may charge fees for establishing the IRA consistent with the regulation, ongoing fees are limited to the amount of income earned by the IRA (i.e., the general restriction that was dropped from the regulation applies in this situation).

Essentially, this exemption means that IRA providers are not required to use their competitors to service their own retirement plans' automatic rollovers.

Implications for Plan Sponsors

From a plan sponsor perspective, it will become increasingly common to consider whether a potential trustee's retail side provides these automatic rollover IRAs as part of its services. This will likely be an additional consideration by the plan sponsor as it reviews the suite of services an institution offers when selecting a trustee. With specific regard to JPMorgan Chase, our Retirement Plan Services Group is currently in the process of conducting a strategic review to determine the viability of supporting automatic rollover IRAs. We will keep you informed of product availability in this area.

As Yet Unresolved

Some financial institutions have raised the concern that under some states' laws, the account holder is required to sign an account document opening the account. The DOL noted that it did not have authority to address this issue. On the other hand, customer identification programs (CIP) under the U.S. Patriot Act don't apply to these types of accounts until the individual actually exerts control over the account. In short, the financial institution is not required to pursue CIP procedures when the plan sponsor opens the account for the participant. Instead, it is required to pursue CIP procedures only once the participant contacts the institution to request a withdrawal or to change the investment vehicle.

Long-Awaited Clarification Regarding Missing Plan Participants

What does a plan fiduciary need to do in order to fulfill its obligations under ERISA with respect to locating a missing participant of a terminated defined contribution plan when efforts to communicate with a missing participant fail to secure a distribution election? Previously, with no guidance from the DOL, fiduciaries were truly wedged between a rock and a hard place when it came to locating missing participants.

Right on the heels of the final DOL regulations regarding the safe harbor for automatic rollovers comes the recent clarification — long-awaited and most welcomed — and guidance from the DOL regarding locating missing plan participants. For the first time, the DOL has issued a structured approach for plan sponsors along with distribution guidance in order to get a plan liquidated and effectively terminated.

Four Necessary Search Methods Outlined

While the guidance itself outlines requirements for fiduciaries and their responsibility to act prudently and solely in the interest of the plan's participants and beneficiaries, the guidance boils down to four mandated steps that a fiduciary must follow in an effort to locate a missing participant or beneficiary before the fiduciary determines that the participant cannot be found and distributes his or her benefits in accordance with other DOL guidance. It is important to note that a plan fiduciary is not obligated to take each of these steps if one or more of them are successful in locating the missing participant. These methods are:

1. Use Certified Mail. A cost effective method, certified mail can be used to ascertain whether the participant can be reached in order to distribute benefits.

2. Check Related Plan Records. While the records of the terminated plan may not have current address information, it is possible that the employer or another plan of the employer, such as a group health plan, may have more up-to-date information. For this reason, plan fiduciaries of the terminated plan must contact both the employer and administrator(s) of related plans to search their records for a more current address for the missing participant.

3. Check with Designated Plan Beneficiary. Plan fiduciaries must try to identify and contact any individual that the missing participant has designated as a beneficiary. If there are privacy concerns, the fiduciary can request the beneficiary to contact or forward a letter to the participant, requesting contact.

4. Use a Letter Forwarding Service. Both the IRS and the Social Security Administration (SSA) offer letter-forwarding services. Plan fiduciaries must choose one and use it in an attempt to locate the missing participant. Helpfully, the DOL stated that the plan fiduciary may set a deadline by which the participant must respond when this method is used.

What if these methods fail? Plan sponsors are then asked to consider additional search options, such as internet search tools or commercial locator services. The plan sponsor can ultimately charge the cost of these additional services to the participant's account, provided it has complied with earlier DOL guidance on allocating expenses to participants (such as disclosure to participants that such an expense would be charged), and provided the size of the account balance is considered relative to the cost to be charged. If the account balance is small, the plan sponsor may decide to dispense with this step.

Once all required search options are exhausted and the missing participant cannot be found, the most favored default option under this guidance is a rollover to an IRA. For terminating defined contribution plans, the DOL has determined that the safe harbor rules described above can be used for account balances over $5,000.

Escheat Now an Option

If the fiduciary cannot find an institution that is willing to accept a rollover IRA, and there is no other defined contribution plan of the sponsor to which the participant's account can be transferred, there are two alternatives. One is a federally insured bank account, and the other — which is truly a sea change for the DOL — is to escheat the funds to a state unclaimed property fund. This is a huge departure from the DOL's previous position, which prohibited escheat under any circumstances. Now, transferring the missing participant's account balance from a terminated DC plan to either such a bank account or an unclaimed property fund is considered a plan distribution, thereby ending both the property owner's status as a plan participant and the property's status as plan assets under ERISA.

In deciding between a federally insured bank account and a state unclaimed property fund, fiduciaries are asked to consider or evaluate any interest accrual fees associated with a bank account against the availability of the state unclaimed property fund's searchable database that may facilitate the potential for recovery. In any event, transfer of the funds to state unclaimed property funds must comply with state law requirements. This is practical and useful guidance that is welcome news for plan sponsors and their institutional trustees.

More to Come

The Department of Labor has indicated that a third piece of guidance for institutional trustees on dealing with abandoned plans will be forthcoming. ○○○

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